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No. 07-735

IN THE

Supreme Court of the United States

ALFRED D. HUGHES AND EL PASO HOLDING CORPORATION,

Petitioners,

v.

UNITED STATES OF AMERICA,

Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Federal Circuit

REPLY BRIEF FOR THE PETITIONERS

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The Government's Opposition characterizes a remarkable legal ruling of the Federal Circuit, that contravenes both established principles of law and

decisions of this Court, as "factual" and without prospective effect. That is not a fair reading. The trial court heard the evidence and, largely on the testimony of the government's own witnesses, concluded that the only consideration provided by the government was the goodwill forbearance. The Federal Circuit did not alter this conclusion or dispute the facts that supported it. Instead, it fashioned a new principle of law, that "regulatory approval" by itself is enough to sustain a contract. The facts of the case, accordingly, are not at issue. The petition presents for the Court's review the pure legal question whether regulatory approval alone is sufficient to sustain a contract.

Justice Scalia, in his concurrence in *United States v. Winstar Corp.*, 518 U.S. 839 (1996), made it clear that the answer to this question is no. Joined by Justices Kennedy and Thomas, he observed that

notwithstanding regulatory approval, the government's agreement to grant a forbearance for only so long as it wished was an "absolutely classic description of an illusory promise" that vitiated the contract. 518 U.S. at 921. The Federal Circuit, which understood that its novel principle of law regarding regulatory approval ran headlong into Justice Scalia's reasoning, candidly dismissed Justice Scalia's point by stating that "[i]n our view, Justice Scalia's position, far from representing the majority view, itself is a minority view on this particular issue." Pet. App. 10a. The Solicitor General, presumably unwilling to fully endorse the Federal Circuit's pronouncement on regulatory approval, gives lip service to the court of appeals' ruling, and then asserts that other consideration was provided in this case – an argument that has no basis in the

record, was rejected by the trier of fact, and was never even presented to the Federal Circuit.

The Solicitor General also contends that this case has little prospective application because the *Winstar* cases, a result of the 1980s savings and loan industry collapse, are nearly at an end. This overlooks the fact that history repeats itself. It is true that after 20 years of litigation these cases are dwindling. However, the government's willingness to repudiate its obligations whenever it appears expedient to do so will haunt it, unless the Court intervenes. Today's headlines already proclaim the newest financial crisis involving subprime mortgages. As we write, delinquencies and foreclosures are rising, and the Chairman of the Board of Governors of the Federal Reserve has implored financial institutions to make accommodations and concessions to subprime

borrowers, in order to avert a national financial crisis. If the past is prologue, then the rulings of the Federal Circuit in the *Winstar* cases, embodying the novel principles of law it employs only against those who sue the government, and the government's shameless handling of the *Winstar* cases, will make private parties reluctant to join hands with the government in other bail-out ventures.

I. REGULATORY APPROVAL IS NOT CONSIDERATION.

The government characterizes the court of appeals' ruling, that regulatory approval is adequate consideration, as a "fact-bound disagreement that does not warrant this Court's review." Op. at 9. However, the question whether regulatory approval is sufficient to sustain a contract, when the government has eliminated the bargained-for consideration, is a legal issue. There are no facts in

dispute: the trial court found that the only consideration bargained for, or received, was the goodwill forbearance and the court of appeals did not disturb that ruling.

Until its one sentence ruling in this case, the Federal Circuit consistently rejected, as a matter of law, arguments that a contract with the government was formed when a federal agency granted its approval for an acquisition. *See First Commerce Corp. v. United States*, 335 F.3d 1373 (Fed. Cir. 2003) (declining to find a contract based on regulatory approval alone); *Fifth Third Bank of W. Ohio v. United States*, 402 F.3d 1221, 1234 (Fed. Cir. 2005) ("[m]ere approval of a merger by the FHLBB, acting solely in its regulatory capacity, did not create contractual obligations."). In changing its mind in this case, the Federal Circuit failed to acknowledge its own previous contrary rulings, failed to explain its

reasoning, and failed to support its pronouncement with any case law. The Federal Circuit did understand, however, that there was no way to harmonize its views with those of Justices Scalia, Kennedy and Thomas. Accordingly, it dismissed their contrary conclusion in *Winstar* as an aberrant "minority view."

The Solicitor General similarly declines to support his position except in the most superficial and unconvincing manner. He states that "regulatory approval was adequate consideration to support the alleged contract," Op. at 8, but goes no further, in terms of legal analysis, than this unsupported assertion. Instead, he mischaracterizes what occurred in this case. He asserts that by obtaining regulatory approval the Petitioners "obtained control of a valuable thrift franchise by providing it with debt-encumbered properties. As a

result, petitioners were able to retain control of those assets while using the thrift's funds to resolve the debts. Indeed, the thrift paid off debts for which petitioner Hughes was personally liable." Op. at 9. What the Solicitor General fails to acknowledge is that it was not even contested in the court of appeals that the net value of the real estate contributed was $35 million, which was in addition to $11.5 million in subordinated debt that Hughes purchased.

Further, to assert that Petitioners obtained control of "a valuable thrift franchise" is wishful thinking. The goodwill forbearance raised El Paso from insolvency; the chief government negotiator and senior official testified that without the goodwill forbearance El Paso "would never have been allowed to open." Pet. App. 131a. Petitioners acquired a bankrupt institution that would not have survived, indeed would not been allowed to open its doors, had

Petitioners not accepted in good faith the government's offer of a goodwill forebearance, and in return for that sole consideration proceeded to merge the old institution into a new thrift, and to infuse tens of millions of dollars in property and other assets to that new institution.

Moreover, the debt pay-off on the property was not provided by the government but by the financial institution owned by the Petitioners. As the trial court correctly ruled, "to the extent Hughes and/or the Holding Company benefited from the thrift's payment of debt on the property . . . those benefits were neither received from the government nor paid as a requirement of the contract." Pet. App. 128a. In any event, there was no *net* benefit to the Petitioners, for Petitioners' asset, El Paso, paid the debt and was

diminished by the amount of the pay-off.[1] Finally, in this lawsuit Hughes only seeks to recover his net equity contribution. Accordingly, whether debt was paid on the properties contributed to El Paso, and by whom, is irrelevant.

Apart from this mischaracterization of the record, the government does not muster a single legal argument in support of its novel principle of contract law, applicable only to the government, that mere regulatory approval is consideration. The government does not acknowledge that, in *Winstar*, the Court confronted a situation virtually identical to that here, and yet notwithstanding regulatory approval, *and* an assistance agreement by which the government contributed cash to the financial institution, the Court concluded that the withdrawn

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[1] Under the government's logic, giving a dollar and receiving back five cents means that the payor is receiving

goodwill forbearance constituted an illusory promise. Asserting that regulatory approval should take on a new life as consideration, therefore, also contradicts the plurality ruling in *Winstar*.

II. BECAUSE THE ONLY CONSIDERATION IN THIS CASE WAS A GOODWILL FORBEARANCE, THE FEDERAL CIRCUIT WAS REQUIRED TO READ THE AGREEMENT TO AVOID FINDING AN ILLUSORY PROMISE.

1. In an attempt to avoid admitting that the only consideration in this case was the goodwill forbearance, the government contends that the goodwill forbearance "was only one of several [forbearances] that the government granted in connection with the approval." Op. at 9. It asserts that there was sufficient consideration in light of these additional forbearances. Op. at 10.

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consideration because he is receiving a nickel.

This response of the government cannot be credited. First, to make its argument with respect to the additional forbearances, the government has been forced to renounce the testimony of its own witnesses at trial that the only bargained-for consideration was the goodwill forbearance and that, without this forbearance, the new thrift would never have been permitted to open its doors. Op. at 10 n.2. As the government's lead negotiator and senior regulator, James Satterfield, testified under oath, the goodwill forbearance was the only obligation the government was contractually obligated to provide. Pet. App. 130a. In addition, "El Paso would never have been allowed to open" without the goodwill forbearance, since it would have been insolvent and subject to immediate seizure. *Id.* Another federal regulator, Janet Hovey, testified similarly. Pet. App. 131a. It is black-letter law that consideration

consists of a bargained-for promise or performance. Restatement (Second) of Contracts § 71 (1981). The only bargained for consideration in this case was the goodwill forbearance, and the government errs by claiming otherwise.

Second, it is undisputed that the sum total of the alleged additional forbearances would not even satisfy the peppercorn test for consideration. As the trial court ruled, "the other forbearances [] are or were of value only if the thrift was open . . . . Remove the goodwill forbearance from the bundle of forbearances and there is no bundle at all." Pet. App. 132a.

Finally, the government never argued before the Federal Circuit that additional forbearances constituted consideration, and the Federal Circuit decision makes no reference to this matter. This Court does not consider points raised by a

respondent, when those matters were not presented to the court below. *Glover v. United States*, 531 U.S. 198, 205 (2001); *Ryder v. United States*, 515 U.S. 177, 184 n.4 (1995).

2. The government also errs in the facile argument that even if the consideration provided was illusory, that would only mean no contract was formed and thus Petitioners would not be entitled to any relief. Op. at 11. The government quite obviously misstates Petitioners' argument. Petitioners do not contend there was no contract but that the Federal Circuit was obligated to construe the contract in a manner that avoided an illusory promise. When presented with an illusory promise, a court may either find the promise unenforceable or, read substance into the promise to prevent it from being illusory. 1 E. Allan Farnsworth, *Farnsworth on Contracts* § 2.13 (3d ed. 2004). Courts are to

choose the latter course, where possible. *Id*; *see also Cherokee Nation v. Leavitt*, 543 U.S. 631 (2005) (rejecting construction that would have made contract illusory); *Mobil Oil Exploration & Producing Se., Inc. v. United States*, 530 U.S. 604, 620 (2000) (affirming a contract interpretation that would not "render the bargain illusory") (quotations omitted).

Here, the Federal Circuit could have preserved the contract by a reasonable reading of the risk-of-regulatory change provision contained in the Regulatory Capital Maintenance Dividend Agreement, or by viewing the RCMDA as a separate contract that did not affect the supervisory goodwill forbearance. The Federal Circuit, accordingly, could have concluded that the provision only required compliance with required regulatory capital levels, as the name of the document itself suggests, even if those capital requirements changed in the future, but

did not obligate Petitioners to assume the risk that the consideration that formed the basis of the bargain would be eliminated by the government, at its whim, at a subsequent date. Such a reading, which is the very reading given the provision by the trial court, would have been consistent with the Court's *Winstar* decision. The *Winstar* plurality recognized what Justice Souter characterized as the "madness" of construing a contract to require a party to assume the risk of regulatory change when, without the goodwill forbearance, the acquired thrift would immediately fail. 518 U.S. at 863-64.

The government contends that the *Winstar* plurality decision "affirmatively supports the decision of the court of appeals." Op. at 11. It asserts that the plurality recognized that a contract could allocate to one of the parties the risk of regulatory change, and in support of that principle, cited with approval

the Eleventh Circuit's decision in *Guaranty Financial Services, Inc. v. Ryan*, 928 F.2d 994 (11th Cir. 1991). This discussion, in a footnote to the plurality opinion, 518 U.S. at 869 n. 15, does not carry the meaning the government assigns it. Despite the plurality's oblique reference to the Eleventh Circuit's decision in *Guaranty*, the plurality decision did not address the issue presented here, which is whether language in an agreement, less than clear, could shift the risk of regulatory change to a private party when such a shift would eliminate the only consideration provided by the government.[2] However, the plurality ruling in *Winstar*, and Justice Scalia's concurrence, strongly

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[2] The government claims that whether the Court addressed the issue is irrelevant because "[t]he risk allocation language in petitioners' alleged contract did not eliminate the regulatory approval, which the court of appeals held was adequate consideration." Op. at 13 n.4. We have already shown that the regulatory approval argument is without merit and in fact is the very argument that the Solicitor General declined to make in the past.

indicate that the Court's answer to this question, if directly presented, would be no. *See Franconia Assocs. v. United States,* 536 U.S. 129, 142 (2002) (rejecting the Federal Circuit's interpretation of contracts established by a statutory scheme when that interpretation would render the government's obligation "meaningless," and would result in a contract that was illusory). The government's argument, based on the *Winstar* footnote, should be rejected.

III. THE FEDERAL CIRCUIT'S NEW GOVERNMENT-FRIENDLY CONTRACT RULES CAN BE APPLIED TO ANY CONTRACT WITH THE GOVERNMENT AND THUS WILL HAVE A SIGNIFICANT PROSPECTIVE EFFECT.

The government attempts to cabin the Federal Circuit's wayward rulings by asserting that because they arise in a *Winstar* case, they have no prospective application. However, the legal issues presented

here are not confined to *Winstar* cases but have broad application. The current sub-prime mortgage crisis, which is widely predicted to be more severe than the savings and loan crisis of the 1980s, is a reminder that the government must from time-to-time seek the aid of its citizens' private capital. To do so, the government typically offers some form of regulatory flexibility or forbearance. Expanding the government's ability to avoid its contractual obligations, as the Federal Circuit has done here, "undermin[es] the Government's credibility at the bargaining table and increase[s]the cost of its engagements." *Winstar*, 518 U.S. at 884. The rulings of the Federal Circuit in this case, accordingly, will affect a wide variety of agency actions and will prove adverse to the government's own interests, as it attempts to muster private parties to solve important national problems.

CONCLUSION

The petition for a writ of certiorari should be granted. The Court may wish to consider summary reversal of the court of appeals' judgment and reinstatement of the well-reasoned decision of the trial court.

Respectfully submitted,

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